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Promoting the Transfer of U.S. Technology Across National Borders: The Enemy within

Antonio Mendoza

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Promoting the Transfer of U.S. Technology Across National Borders: The Enemy within

Cover Page Footnote

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Promoting the Transfer of U.S. Technology Across National Borders: The Enemy Within

Antonio Mendoza†

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I. The Conflict in U.S. Policy

A. Introduction

The United States is a net technology exporter.¹ Promoting technology exportation is profitable not only for U.S. companies, but for the U.S. economy as well.² However, American companies and U.S. policy makers place importance on protecting transferred technology.³ Congress acts mainly through domestic law in its efforts to protect the transferred technology.⁴

¹ Technology is property created by the mind. For purposes of this Article, the terms intellectual property, technology, and intangible property are used interchangeably encompassing the broad Internal Revenue Code definition:

any . . . patent, invention, formula, process, design, pattern, . . . knowhow[,] . . . copyright, literary, musical . . . or artistic composition[,] . . . trademark, tradename, . . . brandname[,]. . . franchise, license, . . . contract[,] . . . method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, . . . technical data[,] . . . or . . . any similar item, which has substantial value independent of the services of any individual.

I.R.C. § 936(h)(3)(B) (1986).

² In 1990, U.S. receipts on international patent and license transactions were \$15.3 billion; expenditures were \$2.7 billion. These figures reflect a net export surplus of \$12.6 billion. See Daniel F. Perez, *Exploitation and Enforcement of Intellectual Property Rights*, 10 COMPUTER LAW., No. 8, at 10, 17 (1993).

³ United States International Trade Commission, Foreign Protection of Intellectual Property Rights and the Effect on US Industry and Trade: Report to the United States Trade Representative, USITC Pub. 2065, Inv. No. 332-245, at vii-viii (Feb. 1988) [hereinafter USITC Report].

⁴ The Constitution gives Congress the power "[t]o promote the [p]rogress of science and useful [a]rts, by securing for limited [t]ime to [a]uthors and [i]nventors the exclusive right to their respective [w]ritings and [d]iscoveries." U.S. CONST. art. I, § 8, cl. 8.

Federal statutory law protects: patents, United States Patents Act, Pub. L. No. 593-950, 66 Stat. 792 (1952) (codified as amended at 35 U.S.C. §§ 1-376 (1988)); trademarks, Trademark Act of 1946, Pub. L. No. 489-540, 60 Stat. 427 (codified as amended at 15 U.S.C. §§ 1051-1127 (1988)); and copyrights, Copyright Act of 1976, Pub. L. No. 94-553, 90 Stat. 2541 (codified as amended at 17 U.S.C. §§ 101-1010 (1988 & Supp. IV 1992)). Intellectual property broadly included in trade secrets and know-how is protected by state law. See, e.g., CAL. CIV. CODE § 3426 (West 1994). The international legal system does not protect intellectual property rights as effectively as domestic systems. For a discussion of international treaties that protect intellectual property rights, and their relative ineffectiveness due to their lack of enforcement power and dispute settlement mechanisms, see Marshall A. Leaffer, *Protecting United States Intellectual Property Abroad: Toward a New Multilateralism*, 76 IOWA L. REV. 273, 275-76, 292-94 (1991). Some commentators argue that the General Agreement on Tariff and Trade (GATT), which provides a forum for negotiations and has enforcement mechanisms not available in other multilateral treaties, would be more effective in the international protection of intellectual property rights. *Id.* at 300. At the time of this writing, the effect of the *Agreement on Trade Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods*—negotiated in the Uruguay round of the GATT talks and signed on April 15, 1994—on the international protection of intellectual property rights is not known. GATT, *Agreement on Trade Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods*, reprinted in 33 I.L.M. 81 (1994). The agreement should provide some protection; it provides that "members shall ensure that enforcement procedures . . . are available under

The main goal of American companies is to preserve the financial value of the technology through license and franchise agreements. The U.S. government, wishing to protect the technology, takes aggressive action against counterfeiting, piracy, and other real or perceived⁵ unfair business practices of foreign companies or their governments.⁶

The U.S. government, however, has competing interests in regulating technology transfer. It desires to: (1) promote the transfer of technology and protect its financial value; (2) inhibit, for national security purposes, the transfer of certain technology;⁷ and (3) prevent the erosion of the U.S. tax revenue base.⁸

Congress reacts to these competing interests by enacting legislation. National security legislation is designed to inhibit the transfer of technology in certain cases; tax legislation is not designed to do so, but in fact, may inhibit the transfer of technology.

This Article reviews—in the context of a hypothetical company (High-Tech, Inc.)—the international agreements, federal legislation, and regulations that address the competing interests of U.S. policy makers. It focuses on federal tax statutes and regulations used to curb improper tax strategies.⁹ It argues that the law creates uncertain tax burdens for U.S. companies, such as High-Tech, and concludes that technology transfer across national borders is inhibited by the enemy within—the uncertainty of the tax cost.¹⁰ The Article calls for an end to the uncertainty by offering several possible solutions.¹¹

their [national] law[s] so as to permit effective action against any act of infringement of intellectual property rights covered by this Agreement . . .” *Id.* at 99.

⁵ Legislation aimed at stopping perceived unfair business practices by foreign states or foreign companies has increased recently. This legislation raises the question of whether unfair business practices by foreign states have increased, or whether the United States merely perceives an increase in such practices given our economic reversal of fortune and massive federal deficit. For a discussion of this issue, see generally Antonio Mendoza, *The Creeping Breach of International Law*, 16 LOY. L.A. INT’L & COMP. L.J. 107, 108 (1993).

⁶ Unfair methods of competition specifically include the infringement of copyrights, patents, and trademarks. 19 U.S.C. § 1337(a)(1)(B)-(C) (1988). The principal U.S. trade negotiating objective is “to seek the enactment and effective enforcement by foreign countries of laws which . . . recognize and adequately protect intellectual property . . . [and] provide protection against unfair competition.” Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 1101(b)(10)(A), 102 Stat. 1107, 1134-35 (codified at 19 U.S.C. § 2901).

⁷ Congress aptly described these competing interests: “It is the policy of the United States to use its economic resources and trade potential to further the sound growth and stability of its economy as well as to further its national security and foreign policy objectives.” 50 U.S.C. app. § 2402(4) (1988).

⁸ Technology has enormous value in the U.S. economy. In 1986, out of 736 firms surveyed nationally, 245 firms, representing sales of \$ 1.114 trillion, reported that 80% of their sales were directly affected by intellectual property rights. USITC Report, *supra* note 3, at viii. In 1986, it was estimated that the loss of revenue as a result of inadequate intellectual property protection amounted to \$23.8 billion in the United States. *Id.*

⁹ See *infra* part IV.

¹⁰ See *infra* part V.A.2.

¹¹ See *infra* part V.B. discussing possible solutions.

B. The Hypothetical Case of High-Tech, Inc.

In our hypothetical, High-Tech is a new innovative high technology company, highly successful in developing patents and manufacturing products in the United States. It has been granted a patent on a widget that is designed for nonmilitary applications but which can be converted to military use. Research and development costs for the invention amounted to \$100,000. High-Tech believes that widget sales will be very good in Latina, a developing country.

High-Tech would rather manufacture the widget in the United States and simply sell it in Latina through a Foreign Sales Corporation.¹² However, the tax law does not permit its use in this case as intangible property is involved, and such property is considered nonexportable.¹³ In addition, as a condition to entering the Latina market, that government is requiring the use of a Latina corporation and the establishment of a manufacturing plant there.¹⁴

High-Tech formed Latina, S.A., a Latina corporation, as a wholly owned subsidiary, capitalizing it by purchasing \$300,000 of its capital stock. High-Tech then entered into a royalty agreement with Latina, S.A., basing royalties on a patent value of \$200,000.¹⁵

The foregoing business plan, while relatively simple, illustrates several areas of risk confronting exporters of technology. High-Tech faces the following uncertainties: (1) Will it lose its technology, or the profits from the sale of the manufactured widget?¹⁶ (2) Will its intellectual property rights be protected?¹⁷ (3) Will the U.S. government allow

¹² A Foreign Sales Corporation is any foreign corporation meeting: (a) the organizational requirements of I.R.C. § 922 (a) (1) (1986), including being organized in an eligible jurisdiction, with no more than 25 shareholders, having no preferred stock outstanding and having at least one nonresident on the board of directors; and (b) the foreign presence requirements of I.R.C. § 924(b)(1) (1986). See generally I.R.C. §§ 921-928 (1986).

¹³ The Foreign Sales Corporation regime, I.R.C. §§ 921-928, provides a partial exclusion from U.S. taxation on income, I.R.C. § 921(a), from sales of certain export property, I.R.C. §§ 924(a)(1), 927(a), if certain foreign management and economic process requirements are met. I.R.C. § 924(b)-(e). It would appear that the Foreign Sales Corporation tax regime could have reduced High-Tech's tax bill; however, this regime cannot be used in the context of this hypothetical since intangible property cannot be export property. I.R.C. § 927(a)(2)(B).

¹⁴ Trade regulation by developing countries is generally stricter and more pervasive than that of developed countries. Developing countries use trade regulation to increase financial and economic stability, improve their foreign currency position, expand their technological base, increase employment, protect their infant industries, or in any other manner which will increase the standard of living of their citizens. See generally Robert J. Radway, *Antitrust, Technology Transfers and Joint Ventures in Latin American Development*, 15 LAW. AM. 47 (1983); Michael W. Gordon, *The Contemporary Mexican Approach to Growth with Foreign Investment: Controlled but Participatory Independence*, 10 CAL. W. L. REV. 1 (1973).

¹⁵ Assume that the exact fair market value of the patent cannot be determined at the present time. Not having an exact comparable, the \$200,000 value represents industry averages for similar products.

¹⁶ See *infra* notes 20-26 and accompanying text.

¹⁷ See *infra* notes 27-40 and accompanying text.

the transfer of technology to Latina?¹⁸ (4) What is the tax cost of the sale transaction with Latina, S.A.?¹⁹

II. U.S. Efforts to Protect and Enhance the Transfer of Technology by U.S. Persons

A. *The Dual Risk of Technology Transfer*

Once High-Tech has transferred its patented widget technology to Latina, S.A., its business plan may be thwarted in various ways. First, it may lose the technology outright.²⁰ Less dramatically, it may have its profits diluted through counterfeiting, piracy, or the gray market.²¹

U.S. law creates a distinction between counterfeiting/piracy and gray market sales.²² It aggressively attempts to curtail counterfeiting and piracy, while permitting U.S. gray market sales.²³ If a gray market emerges,²⁴ High-Tech will probably not have any legal recourse.²⁵ However, if the widget is counterfeited or pirated, formidable statutory and treaty relief is available to High-Tech.²⁶

B. *The Attack on Counterfeiting and Piracy*

The United States attacks counterfeiting and piracy both at the international²⁷ and domestic levels.²⁸ Domestically, federal legisla-

¹⁸ See *infra* notes 41-51 and accompanying text.

¹⁹ See *infra* notes 52-106 and accompanying text.

²⁰ Developing countries, for reasons ranging from cultural attitudes toward private property, availability of essential commodities, and political environment, do not have a problem with appropriating new products and technologies from foreigners—especially from foreigners in developed countries. Therefore, the risk of losing the technology is very real. See Alan S. Gutterman, *The North-South Debate Regarding the Protection of Intellectual Property Rights*, 28 WAKE FOREST L. REV. 89, 107-10 (1993).

²¹ "Parallel imports, or grey market goods, are goods manufactured outside the target country bearing trademarks duly registered in their country of manufacture that are sold in the target country in competition with the same goods produced by the target country's authorized manufacturers or distributors . . ." See generally Harry Rubin, *Destined to Remain Grey: The Eternal Recurrence of Parallel Imports*, 26 INT'L LAW. 597, 597 (1992).

²² See *infra* notes 23-26 and accompanying text.

²³ The U.S. Customs Service interprets § 526 of the Tariff Act of 1930, 46 Stat. 741 (codified as amended at 19 U.S.C. § 1526 (1988)), as allowing the entry of gray market goods when the trademark is owned by the same person or when the owners are subject to common ownership or control. 19 C.F.R. § 133.21(c)(1) (1987). The Supreme Court has ruled that the Customs' view is a reasonable interpretation of the statute. *K Mart v. Cartier, Inc.*, 486 U.S. 281, 294 (1988).

²⁴ A gray market emerges when a currency value fluctuates. The fluctuation causes a price differential for the same goods. A disparity in the U.S. price versus the foreign price creates an incentive to purchase the product abroad and resell in the United States. See David Bender & David A. Gerber, *In Wake of High Court Decision, The Gray Market Gets Grayer*, NAT'L L.J., Sept. 19, 1988, at 15.

²⁵ But see *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1174 (S.D.N.Y. 1984) (denying importation of gray market goods when party opposing importation showed that it had "developed in the United States marketplace a substantial goodwill separate and distinct from the goodwill emanating from the branded goods themselves").

²⁶ See *supra* note 4 and *infra* notes 28-40 and accompanying text.

²⁷ See *supra* note 4 for a discussion of multilateral international efforts to protect intellectual property rights.

²⁸ See *supra* note 4.

tion²⁹ provides relief against piracy and counterfeiting of trademarks,³⁰ copyrights,³¹ and patent infringement.³²

While it is clearly U.S. policy to curb counterfeiting, direct action against counterfeiters is rather ineffectual.³³ Even the potent statutory relief preventing the product's importation is hampered by a narrow Customs' interpretation³⁴ and by the enormous logistical problem of locating the port of entry of counterfeit goods. Recognizing the practical difficulties in finding and prosecuting counterfeiters, and recognizing that certain countries are notorious for allowing counterfeiters to operate within their borders,³⁵ Congress has authorized unilateral action by the United States Executive Branch to encourage change in the offending country's policy towards counterfeiters.³⁶ The United States also uses a carrot³⁷ and stick³⁸ approach in urging certain of its treaty

²⁹ The Tariff Act of 1930 makes it unlawful to import articles into the United States that infringe on valid and enforceable U.S. patents, copyrights, or trademarks. 46 Stat. 741 (codified as amended at 19 U.S.C. § 1337(a)(1) (1988)). Relief under the Act includes: denial of entry of the goods into the country, 19 U.S.C. §§ 1337(d), 1526(a) (1988); seizure and forfeiture, 19 U.S.C. §§ 1337(i), 1526(b) and (e) (1988); and injunctive relief and damages against any person dealing in such merchandise, 19 U.S.C. §§ 1337(f)(1)-(2), 1526(c) (1988).

³⁰ The Trademark Counterfeiting Act of 1984 imposes criminal penalties for the intentional trafficking or attempted trafficking in goods with counterfeit marks. Pub. L. No. 98-473, §§ 1501-1503, 98 Stat. 2178, 2179 (codified as amended at 18 U.S.C. § 2320 (1988)).

³¹ It is unlawful to import copyrighted material without the authorization of the owner. 17 U.S.C. § 602(b) (1988). If such goods are found in the United States, they are subject to seizure. 17 U.S.C. § 603(c) (1988).

³² 19 U.S.C. § 1337(a)(1) (1988).

³³ Statutory penalties are illusory since obtaining jurisdiction over foreign defendants is very difficult. See, e.g., *In the Matter of Certain Personal Computers and Components Thereof*, USITC Pub. 1504, Inv. No. 337-TA-140 (1984) (20 defendants were named, only 2 bothered to participate).

³⁴ The U.S. Customs Service has historically interpreted the statute narrowly. For example, computers alleged to be in violation of Apple Computers copyrights were allowed into the country because the "Read Only Memory" operating unit had been removed by the importer. See *Importation of 'Rom-less' Computers Not Barred Under § 602(b) of Copyright Act*, U.S. Import Wkly. (BNA) No. 9, at 1062 (May 30, 1984).

³⁵ Mexico, Brazil, Korea, Taiwan, and China are frequently cited for failing to protect intellectual property rights. See Gutterman, *supra* note 20, at 97.

³⁶ Under federal law, the United States Trade Representative (USTR) is required to identify "those foreign countries that . . . deny adequate and effective protection of intellectual property rights, or . . . deny fair and equitable market access to United States persons that rely upon intellectual property protection . . ." 19 U.S.C. § 2242 (1988). Once a country is identified, the USTR may open an investigation with respect to any suspect act, policy, or practice of that country. 19 U.S.C. § 2412 (1988). Upon a negative finding by the USTR, broad authority is given to him "to . . . suspend, withdraw, or prevent the application of, benefits of trade concessions to carry out a trade agreement with the foreign country referred to in such subsection; . . . impose duties or other import restrictions on the goods of . . . such foreign country for such time as the Trade Representative determines appropriate." 19 U.S.C. § 2411(c) (1988).

³⁷ The carrot is the Generalized System of Preferences, 19 U.S.C. §§ 2461-2464 (1988), which provides for "duty-free treatment for any eligible article from any beneficiary developing country in accordance with the provisions of this title . . ." 19 U.S.C. § 2461. *Accord* Caribbean Basin Economic Recovery Act, 19 U.S.C. §§ 2701-2706 (1988).

³⁸ The stick is the removal of benefits. See, e.g., 19 U.S.C. § 2464(c)(3)(B) (stating that "the President shall give great weight to . . . the extent to which such country provides adequate and effective means under its law for foreign nationals to secure, to exercise, and to

partners to heighten protection for the intellectual property rights of U.S. persons.

Although the ultimate resolution of the counterfeiting/piracy problem remains unsettled,³⁹ it is clear that the U.S. government promotes technology transfer by aggressively protecting the intellectual property rights of its citizens.⁴⁰ Thus, there is an alliance between the U.S. government and High-Tech against counterfeiters—an alliance that abruptly ends when High-Tech decides to export the widget patent technology.

III. Will High-Tech Be Allowed to Transfer the Widget Patent to Latina, S.A.: National Security Implications of the Transfer of Technology

A basic tenet of international law is that states may regulate the conduct of persons when national security interests are at stake.⁴¹ U.S. statutory law regulating product and technology exports⁴² and inbound capital⁴³ reflects the exercise of this right.

Because the High-Tech transaction contemplates an outbound transfer of technology, it must procure either a general or validated

enforce exclusive rights in intellectual property, including patent, trademark, and copyright rights"). See also 19 U.S.C. § 2702(b)(2)(B) (stating that "the President shall not designate any country a beneficiary country under this chapter . . . if such country . . . has taken steps to repudiate or nullify . . . any patent, trademark, or other intellectual property of, a United States citizen . . .").

³⁹ See *supra* note 4 for a discussion of recent GATT efforts to address the problem.

⁴⁰ In fact, the United States was criticized by a GATT panel for being too aggressive in the use of the statutory trade remedy for patent infringement. See Judith H. Bello & Alan F. Holmer, *U.S. Trade Law and Policy Series No. 16: Settling Disputes in the GATT: The Past, Present and Future*, 24 INT'L LAW. 519, 528-31 (1990). The GATT panel found that the International Trade Commission procedures, the statutory deadlines, the prohibiting of counterclaims, the limitations on the availability of forums and duplicative proceedings, all allowed under U.S. law, creates conditions that unfairly discriminate against foreign companies. *Id.*

⁴¹ Very broad discretion is given to states in prescribing rules it deems appropriate to regulate conduct. "[A] state has jurisdiction to prescribe law with respect to . . . conduct that . . . wholly or in substantial part, takes place within its territory . . . or . . . conduct outside its territory that has or is intended to have substantial effect within its territory. . . ." RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 402(1) (1986).

⁴² The Export Administration Act, Pub. L. No. 96-72, 93 Stat. 503 (1979) (codified as amended at 50 U.S.C. app. §§ 2401-2420 (1988)), regulates the exportation of products or technology. The Act gives great authority to the President to restrict exports. 50 U.S.C. app. § 2404. The President delegated these powers to the Secretary of Commerce. The Secretary responded by developing a licensing system. See generally Export Administration Regulations, 15 C.F.R. §§ 768-799 (1992). Generally, the exportation from the United States of all commodities and technical data is prohibited "unless and until a general license authorizing such export shall have been established or a validated license or other authorization for such export shall have been granted." 15 C.F.R. § 770.3(a) (1992).

⁴³ In August of 1988, fearing impairment of national security if foreign interests were to gain control of high technology U.S. companies, Congress passed the Exon-Florio amendment to the Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 5021, 102 Stat. 1107, 1425 (codified at 50 U.S.C. app. § 2170). The statute empowers the President or his designee, after an investigation, to determine the effect any merger, acquisition, or proposed takeover by a foreign person may have on national security. *Id.* If national security is threatened, the President may suspend or prohibit the acquisition merger or takeover. *Id.*

license.⁴⁴ Among the risks High-Tech faces is that neither type of license may be available. Another risk is that the process may be protracted.⁴⁵ Moreover, stiff penalties⁴⁶ and strict liability⁴⁷ require High-Tech to proceed with great care in seeking to comply with the licensing regime.

National security legislation reflects a deep concern, if not paranoia, that U.S. companies in seeking to tap global markets might impair national security. The existing regulatory mechanism has come under increased criticism—some argue that restrictions on inbound investment are not based on national security concerns but rather are disguised protectionism,⁴⁸ arguably violating international law.⁴⁹ Others contend that export restrictions are anachronistic and needlessly inhibit export profits.⁵⁰

The export control rules facing High-Tech, as burdensome as they may be, still afford a basis for planning the venture. If an export license cannot be obtained, High-Tech cannot do the deal; it may forgo potential profits, but it will not incur the expense of opening the Latina subsidiary. Regardless, it can make its various contractual undertakings contingent upon receiving a license. Sooner or later High-Tech will know its fate. The tax law, however, does not offer such predictability.⁵¹

⁴⁴ 50 U.S.C. app. § 2403.

⁴⁵ Even if a license is ultimately granted, the time delays can be enormous. See, e.g., *Daedalus Enters., Inc. v. Baldridge*, 563 F. Supp. 1345 (D.D.C. 1983) (where the license application process took over 29 months even though the statutory timetable provides an application process time of 240 days). See also 50 U.S.C. app. § 2409.

⁴⁶ Penalties include fines reaching five times the value of the exported goods, or \$1,000,000, whichever is greater; imprisonment for up to ten years; and the loss of export privileges. 50 U.S.C. app. § 2410.

⁴⁷ 15 C.F.R. § 772.1(c) (1993).

⁴⁸ By obtaining governmental intervention on national security grounds, an unwilling target could abuse the process and thwart a valid takeover attempt. See generally Jonathan A. Knee, *Limiting Abuse of Exon-Florio by Takeover Targets*, 23 GEO. WASH. J. INT'L L. & ECON. 475 (1989).

⁴⁹ Exon-Florio can be construed as denying national treatment to foreign nationals, a guarantee promised under many U.S. treaties. See generally Jose E. Alvarez, *Political Protectionism and United States Investment Obligations in Conflict: The Hazards of Exon-Florio*, 30 VA. J. INT'L L. 1, 120-29 (1989); Note, *The Rising Tide of Reverse Flow: Would a Legislative Breakwater Violate U.S. Treaty Commitments?*, 72 MICH. L. REV. 551, 567-92 (1974) (analyzing 11 treaties using the national treatment standard).

⁵⁰ The Clinton administration supports legislation that overhauls the current export licensing system. *Clinton Unveils Export Plan Addressing Controls, Financing*, Int'l Trade Daily, (BNA) (Sept. 30, 1993), available in LEXIS, BNA Library, BNAITD File. Recognizing that the existing export licensing system is a relic from the cold war past, the new system seeks to minimize uncertainty in export controls while not placing U.S. companies at a competitive disadvantage vis-à-vis foreign competitors, unless there is "a significant risk to the foreign policy, nonproliferation or national security interests of the United States. . . ." S. Res. 1902, 103d Cong., 1st Sess. §§ 3, 5 (1994) (enacted).

⁵¹ See *infra* notes 107-10 and accompanying text.

IV. Federal Tax Legislation: What Is the Tax Cost to High-Tech?

A. *The Tax Avoidance Strategy*

Certainty of a transaction's tax cost is a critical factor in any business decision. High-Tech could incur the expense of the Latina subsidiary and lose the potential profits to the tax man. The problem faced by High-Tech is that it partially fits the profile, albeit inadvertently, of the taxpayer in the classic tax avoidance strategy.

The strategy works as follows. A U.S. company develops a high profit patent.⁵² The research and development costs, deductible in the United States,⁵³ reduce U.S. taxable income. Just before the product which is subject to the patent is marketed, which generates sales income,⁵⁴ the U.S. company sells or otherwise transfers the patent to a related foreign affiliate at or below cost.⁵⁵ If organized in a tax haven country,⁵⁶ the affiliate pays no tax in either the tax haven or the United States.

B. *Federal Legislation to Discourage the Tax Avoidance Strategy*

Through the years, Congress has enacted a formidable array of statutes amending the federal income tax system to discourage the tax avoidance strategy.⁵⁷ The question is whether current tax law is a

⁵² Congress targets sales or transfers of high profit intangibles to related parties, believing that improper tax strategies pose "[a] fundamental problem . . . particularly acute in the case of . . . high profit intangibles . . ." H.R. REP. NO. 426, 99th Cong., 1st Sess. 424 (1985).

⁵³ Fifty percent of the research and development expenditures must be allocated to the country where the expenditures are made, and 50% are allocated according to the source of taxpayers gross sales. I.R.C. § 864(f) (1986).

⁵⁴ U.S. citizens pay tax on worldwide income; the only required nexus is citizenship. See *Cook v. Tait*, 265 U.S. 47 (1924). If the U.S. company markets the widget in Latina, it will be taxed on Latina sales income in the United States. To avoid income recognition, the company disposes of the patent before generating income. Avoiding income recognition by the U.S. company while deducting the research and development costs is the first leg of the tax avoidance strategy.

⁵⁵ Foreign corporations pay tax only on U.S. source income, unless they are engaged in a trade or business in the United States. If so, any income from whatever source will also be subject to U.S. tax, so long as that income is effectively connected to the U.S. trade or business. Treas. Reg. § 1.881-1(b) (as amended in 1973). Structuring the transaction so the company earning the income will not be subject to U.S. tax is the second leg of the tax avoidance strategy.

⁵⁶ Generally tax haven countries do not impose income taxes on business operations conducted outside their borders. Tax haven countries include such diverse places as the Cayman Islands, Luxembourg, Hong Kong, and Gibraltar. For a complete listing of popular tax haven countries, see ANTHONY S. GINSBERG, *TAX HAVENS* 14 (1991).

⁵⁷ Two federal income tax systems operate in the United States. One system consists of those rules scattered throughout the Internal Revenue Code. See, e.g., *INTERNATIONAL INCOME TAXATION: CODE AND TAX REGULATIONS, SELECTED SECTIONS* (Richard C. Pugh and Charles H. Gustafson eds., 1993) (a 2,608 page compilation of international code sections and regulations). The other system is the tax treaty network involving over 40 countries. See generally *Tax Treaties Status Table*, 1 *Tax Treaties* (CCH) ¶ 1009, at 1303-05 (1993) (listing all countries that are U.S. treaty partners). We will assume that Latina does not have a tax treaty with the United States. Therefore, the tax implications are determined under the Internal Revenue Code.

proper response to improper taxpayer strategies, or merely a myopic approach resulting from a preoccupation with revenue. A summary of the rules targeting transfers, or sales, of appreciated technology property follows.⁵⁸

1. *The Controlled Foreign Corporation (CFC) Rules [I.R.C. §§ 951-964]*

The Controlled Foreign Corporation tax regime's goal is to prevent improper arrangements between U.S. shareholders and their Controlled Foreign Corporations.⁵⁹ It targets transactions lacking economic or business substance. The tax rules, when they apply, deny entity status to the CFC, treating it essentially as a conduit of the U.S. shareholder.⁶⁰ Thus, any income lacking business or economic substance, i.e., Subpart F income,⁶¹ earned by the CFC is deemed distributed to the U.S. shareholder as it is earned. Only Subpart F income is considered earned by U.S. shareholders. Non-Subpart F income, on the other hand, is generally deferrable by the shareholders, and hence, allows for a delay in the reporting of any CFC income until an actual distribution is made by the CFC.⁶²

2. *The Forced Sale Provision of I.R.C. § 367(d)*

While the CFC tax regime focuses on corporate operations, I.R.C. section 367 addresses the tax issues in the initial funding of a corporation. In a domestic context, if the initial funding is achieved by transferring appreciated intangible property solely in exchange for stock, where the transferor is in control of the corporation after the exchange, the transaction is treated as a change in form only and not a

⁵⁸ See *infra* notes 59-106 and accompanying text.

⁵⁹ A controlled foreign corporation is a foreign corporation where "more than 50 percent of . . . the total combined voting power of all classes of stock of such corporation entitled to vote, or . . . the total value of the stock of such corporation, is owned . . . by United States shareholders." I.R.C. § 957(a) (1986). United States shareholders means "a United States person . . . who owns . . . 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation." I.R.C. § 951(b) (1986).

⁶⁰ "If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder . . . of such corporation . . . shall include in his gross income . . . his pro-rata share . . . of the corporation's Subpart F income for such year" I.R.C. § 951(a)(1) (1986).

⁶¹ Only 'Subpart F' income is deemed distributed. Subpart F income includes income and certain expenditures. I.R.C. § 952(a) (1986). Among the types of income included is the income relevant in our case—foreign based company sales income. I.R.C. §§ 952(a), 954(a) and (d)(1) (1986).

⁶² I.R.C. § 951(a)(1)(A). However, even non-Subpart F CFC income can be classified as distributed to the extent that it is invested in U.S. property. I.R.C. § 951(a)(1)(B). Thus, if the CFC acquires tangible personal property located in the United States; stock of a U.S. corporation; or intangible property for use in the United States, the amounts invested are considered distributed to the U.S. shareholder. I.R.C. § 956(b)(1) (1986). In addition, loans to a U.S. person, including the U.S. shareholder, are also regarded to be distributed. I.R.C. § 956(b)(1)(C).

sale, and thus, the transfer is tax free.⁶³ By contrast, tax-free treatment is not available for analogous transfers involving foreign corporations,⁶⁴ thereby forcing a sale and gain recognition.⁶⁵ Moreover, the income is considered U.S. source,⁶⁶ thus reducing the availability of the foreign tax credit.⁶⁷ If the transaction is structured as a sale, I.R.C. section 482, instead of I.R.C. section 367(d), applies.⁶⁸

3. *The Pre-1986 Reallocation Provision of I.R.C. § 482*

I.R.C. section 482 is a very brief,⁶⁹ but extremely broad, provision. It gives the Secretary of the Treasury⁷⁰ virtually unbridled authority to re-allocate income between related parties, resulting in fact-intensive, costly disputes.⁷¹ As a result, tax exposure on intercompany transactions is difficult to predict.⁷²

High-Tech may avoid the loss of income deferral because even though Latina, S.A., is a CFC, it will probably not have Subpart F income.⁷³ Since High-Tech is transferring the widget patent to Latina,

⁶³ I.R.C. §§ 351(a), 368(c) (1986).

⁶⁴ I.R.C. § 367(a)(1) (1986).

⁶⁵ I.R.C. § 367(a)(3)(A) provides a limited exception to the forced sale rule of I.R.C. § 367(a)(1) in cases where the transfer involves property that is to be used in the active conduct of a trade or business. The trade or business exception, however, is not available on the transference of intangible property. I.R.C. § 367(a)(3)(B)(iv) (1986).

⁶⁶ I.R.C. § 367(d)(2)(C) (1986).

⁶⁷ The foreign tax credit is intended to reduce the negative effects of the worldwide income implications on U.S. persons. See generally I.R.C. §§ 901-908 (1986). The payment of the foreign tax can be credited against U.S. tax liability. Critical to the availability of the tax, however, is the existence of foreign income. I.R.C. § 901(b)(1). The effect of the special I.R.C. § 367(d)(2)(C) rule eliminates the availability of the foreign tax credit.

⁶⁸ I.R.C. § 367 is limited to those transactions involving some form of corporate reorganization. I.R.C. § 367(a) (1986). In all other cases I.R.C. § 482, because of its broader scope, will apply. I.R.C. § 482 (1986).

⁶⁹ Enacted in the 1930s, the pre-1986 Code section read in pertinent part:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such organizations, trades, or businesses.

I.R.C. § 482.

⁷⁰ Only the government can reallocate income under I.R.C. § 482; the taxpayer cannot use § 482 to reallocate income. See *id.*

⁷¹ See *Eli Lilly v. Commissioner*, 84 T.C. 996 (1985) (a 195 page case that demonstrates the fact-intensive nature of an I.R.C. § 482 reallocation issue). The factual nature of the disputes, in turn, creates costs for economists, engineers, lawyers, and others.

⁷² The uncertainty was minimized, however, by allowing the taxpayer relief when she could establish that the stated price was at an arms-length value. Such a finding prevents the Commissioner from applying the reallocation provisions of Section 482. See Marc M. Levey & Stanley C. Ruchelman, *Section 482-The Super Royalty Provisions Adopt the Commensurate Standard*, 41 Tax Law. 611, 621-24 (1988) (discussing the pre-1986 intangible property intercompany pricing rules and the arm's-length standard).

⁷³ Latina, S.A., intends to manufacture and sell the widget in Latina. Thus, the income generated will not be Subpart F income. See I.R.C. § 954(a)(1) (1986).

S.A., through a royalty agreement, the forced sale provision of I.R.C. section 367(d) does not apply.⁷⁴ However, the reallocation of income rules in I.R.C. section 482 do apply. Indeed, the 1986 amendment to I.R.C. section 482 increased High-Tech's exposure.⁷⁵

4. *The Post-1986 Reallocation Provision of I.R.C. § 482: The "Super Royalty"*

a. *The Enactment of the Legislation*

The technique of transferring intangibles to a related foreign corporation in a low or no tax jurisdiction has prompted concern in Congress with taxpayer behavior.⁷⁶ Accordingly, technology transfers,⁷⁷ or licenses,⁷⁸ to foreign corporations, or possessions corporations,⁷⁹ are now subject to a new standard of income allocation.⁸⁰

Dubbed the "Super Royalty,"⁸¹ its purpose is to allocate income from intangibles among the members of the multinational group in a

⁷⁴ See *supra* notes 65-68 and accompanying text.

⁷⁵ See *infra* part IV.B.4.

⁷⁶ The House Report reflects this concern:

There is strong incentive for taxpayer to transfer intangibles to related foreign corporations or possessions corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers can result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group.

H.R. REP. NO. 426, 99th Cong., 1st Sess. 423 (1985).

However, some commentators argue that the super royalty provisions are "really just one more manifestation of the 1986 Tax Reform Act's almost palpable paranoia regarding taxpayer behavior, a paranoia that explains a wide variety of truly bizarre provisions . . ." Richard L. Kaplan, *International Tax Enforcement and the Special Challenge of Transfer Pricing*, 1990 U. ILL. L. REV. 299, 315.

⁷⁷ I.R.C. § 367(d) was amended to require the amount of the forced sale in the case of an intangible to be "commensurate with the income attributable to the intangible." I.R.C. § 367(d)(2)(A) (1986).

⁷⁸ The new standard requires that "[i]n the case of any transfer (or license) of intangible property . . . the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." I.R.C. § 482 (1986).

⁷⁹ Possessions Corporations are corporations formed pursuant to the laws of U.S. possessions as defined in I.R.C. § 936(d)(1) (1986).

In 1982, tax law changes to I.R.C. § 936 gave possessions corporations favored tax treatment on the transfer of appreciated intangible property by removing the applicability of the forced sale provision of I.R.C. § 367. In addition, substantial tax benefits inured to possessions corporations using the cost-sharing option method in accounting for income from intangibles transferred from U.S. companies. Congress was concerned that tax advantages under I.R.C. § 936, claimed by certain taxpayers using possessions corporations, were excessive. H.R. REP. NO. 426, 99th Cong., 1st Sess. 423 (1985). Acting on that concern, I.R.C. § 936(h)(5)(C)(i)(1) was amended in 1986 to require that the cost sharing payment amount shall be commensurate with the income attributable to the intangible. I.R.C. § 936(h)(5)(C)(i)(1) (1986).

⁸⁰ The changes to the Code have been criticized for the uncertainty created for Puerto Rican possessions corporations. *International Taxes: Cost-Sharing Changes in Sec. 482 Proposal Seen Adding to Sec. 936 Firms' Uncertainty*, Daily Tax Rep. (BNA) No. 231, at D-32 (Dec. 1, 1992) (arguing that the changes will retard investment in Puerto Rico).

⁸¹ Congress felt that industry averages were not adequate measures to establish the value of the transferred intangible; it found that "compensation for the intangible should be

manner that reflects the relative economic activities of each.⁸² Although admirable in intent, the new standard is very imprecise. It also reflects questionable policy as it erodes⁸³ the arm's-length standard that the United States has long espoused on an international level.⁸⁴ At least two commentators find the new provision "contradictory" and "unwarranted."⁸⁵

b. The Attempts to Explain the Statute: Searching for Suitable Explanations

Essentially, the 1986 amendment exacerbates the valuation problem that has long plagued intercompany transactions.⁸⁶ Recall that High-Tech formed Latina, S.A., as its wholly owned subsidiary. It then licensed the widget patent for \$200,000 using industry averages to establish the price,⁸⁷ reporting a gain on the sale.⁸⁸ Will the Internal Revenue Service (IRS) agree with High-Tech on the amount of the gain? The answer is maybe, and thus, turns High-Tech's tax planning into a crap shoot.

Congress recognized that important issues were left unanswered by the language in the amendment.⁸⁹ It called upon the IRS to conduct a comprehensive study of the intercompany pricing issue and to modify the rules accordingly.⁹⁰ Two years after the Congressional mandate, the IRS issued its much criticized "white paper" explaining the amendment.⁹¹ In January 1992, four years after the issuance of the

greater than industry averages or norms." See H.R. REP. NO. 426, 99th Cong., 1st Sess. 425 (1985) (hence the term "super royalty").

⁸² H.R. REP. NO. 841, 99th Cong., 2d Sess. II-637 (1986).

⁸³ While not explicitly abandoning the arm's-length standard in the case of intangibles, Congress felt that "[t]here are extreme difficulties in determining whether the arm's length transfer between unrelated parties are comparable. The Committee thus concludes that it is appropriate to require that the payment made on a transfer of intangibles to a foreign related corporation . . . be commensurate with the income attributable to the intangible" H.R. REP. NO. 426, 99th Cong., 1st Sess. 425 (1985).

⁸⁴ See also the discussion on the effect under international obligations in part V.A.3 *infra*. For an analysis of the Congressional reasoning and a discussion of the demise of the arm's-length standard, see Levey & Ruchelman, *supra* note 72, at 628-35.

⁸⁵ Ernest F. Aud, Jr. & Deloris R. Wright, *An Analysis of the Super-Royalty Provisions of the Tax Reform Act of 1986*, 16 TAX MGMT. INT'L J. 17, 19 (1987).

⁸⁶ Valuation problems are nothing new. See generally *Eli Lilly v. Commissioner*, 84 T.C. 996 (1985) (where the dispute involved the valuation of pharmaceutical patents). However, *Eli Lilly* was a 195 page fact-intensive opinion that had little precedential value.

⁸⁷ Under prior regulations, value could be established by the "prevailing rates in the same industry" Treas. Reg. § 1.482-2(d)(2)(iii)(a) (as amended in 1968).

⁸⁸ Establishing a value of \$200,000 and using the adjusted basis of the patent widget as \$100,000, High-Tech would realize a gain of \$100,000. See I.R.C. § 1001 (1986).

⁸⁹ The statute simply states that the value attributed to the intangible must be "commensurate with the income attributable to the intangible" I.R.C. §§ 367(d), 482 (1986).

⁹⁰ H.R. REP. NO. 841, 99th Cong., 2d Sess. II-638 (1986).

⁹¹ See *International Taxes: 482 White Paper Raises Double Taxation Concerns for Foreign Tax Officials*, Daily Tax Rep. (BNA) No. 210, at DER G-3 (Oct. 31 1988) (noting that American tax practitioners are critical of Treasury White Paper); *International Taxes: Section 482 Criticized as Removing Certainty on Cost Sharing Agreements*, Daily Tax Rep. (BNA) No. 210, at DER G-2

"white paper," proposed regulations were issued that largely abandoned many of the "white paper" positions.⁹² The proposed regulations were themselves repealed after much criticism.⁹³ In January 1993, temporary regulations were issued.⁹⁴ Truly, IRS efforts attempting to explain I.R.C. section 482 have been imprecise and unilluminating. Final regulations (which were effective as of July 8, 1994),⁹⁵ while lengthy and detailed, do not provide much certainty to business planners.⁹⁶

*c. The Quest for Certainty Under the Regulations:
Searching in Vain*

The regulations provide several methods to value intangibles:⁹⁷ (1) the comparable uncontrolled transaction method;⁹⁸ (2) the comparable profits method;⁹⁹ and (3) any other method to reach true arm's-length value.¹⁰⁰ The regulations' intangible property valuation methods¹⁰¹ resemble those provided in the regulations for tangible

(Oct. 31, 1988) (Price Waterhouse criticizes White Paper). See generally U.S. TREASURY DEP'T, A STUDY OF INTERCOMPANY PRICING 1988-2 C.B. 458, reprinted in 1988-49 I.R.B. 7-83, and in Standard Fed. Tax Rep. (CCH) No. 53, at 1 (Oct. 20, 1988) (extra ed.).

⁹² See generally Intercompany Transfer Pricing and Cost Sharing Regulations Under Section 482, 57 Fed. Reg. 3571 (1992) (notice of proposed rulemaking under I.R.C. § 482).

⁹³ The proposed regulations were criticized for having gone beyond the statutory amendment and legislative history of the Act. See *International Taxes: IRS' Sec 482 Proposal Seen Over Extending 1986 Commensurate-With-Income Standard*, Daily Tax Rep. (BNA) No. 153, at D6 (Aug. 7, 1992).

⁹⁴ Temp. Treas. Reg. §§ 1.482-0T to 1.482-7T (1994).

⁹⁵ Final Regulations with an effective date of July 8, 1994 (except for sections 1.482-0T through 6T which have an effective date of October 6, 1994) were issued on July 1, 1994. *Internal Revenue Service Final Regulations*, Daily Tax Rep. (BNA) No. 126, at D-42 (July 5, 1994) (Special Supplemental Report). No substantive changes from the Temporary Regulations were made.

⁹⁶ At least one commentator believes that the new rules will increase controversy and decrease certainty. See *Transfer Pricing: IRS Issues Accuracy Penalty Regulations Than Conform To New Section 482 Rules*, Daily Tax Rep. (BNA) No. 127, at D9 (July 6, 1994).

⁹⁷ Temp. Treas. Reg. § 1.482-4T(a)(1) (1994).

⁹⁸ Under this method, arm's-length means the consideration charged, or incurred, in a comparable uncontrolled transaction. Factors used to determine comparability include: the class of the intangible; the type of process, or know-how; and the profit potential of the intangible. Temp. Treas. Reg. § 1.482-4T(c) (1994).

⁹⁹ The comparable profits method relies on the general principle that similarly situated taxpayers will tend to earn similar returns. Temp. Treas. Reg. § 1.482-5T (1994).

¹⁰⁰ The other method, Temp. Treas. Reg. § 1.482-4T(d), is a catch-all provision permitting the taxpayer to use any method that fulfills the purpose of § 482—to ensure that the taxpayer clearly reflects its income by placing a controlled taxpayer on a tax parity with an uncontrolled taxpayer. Temp. Treas. Reg. § 1.482-1T(a)(1) (1994).

The prior regulation's arm's-length value test for intangible property was more subjective; it referred to proper value as that which unrelated parties involving the same, or similar, intangible property under the same, or similar, circumstances would use. Treas. Reg. § 1.482-2(d)(2)(ii) (as amended in 1968). The new rules are more objective, seemingly creating the specificity of the tangible property valuation rules.

¹⁰¹ There is no strict hierarchy among the rules. The regulations merely provide that the best method is the one that provides the most accurate measure of an arm's-length result under the facts and circumstances of the case. Temp. Treas. Reg. § 1.482-1T(b)(2)(iii) (1994).

property.¹⁰² If experience is any guide, however, the "other method" of valuation will be the IRS's preferred method.¹⁰³

The use of the "other method" provision creates additional problems for High-Tech. The temporary regulations place important limitations on the use of the "other method,"¹⁰⁴ by imposing burdensome documentation requirements on the taxpayer,¹⁰⁵ the adherence of which will not necessarily prevent penalties.¹⁰⁶

V. Conclusion

A. *The Effect of the Amendment and the Regulations*

1. *The Uncertainty Impacting High-Tech*

With the passage of a one-sentence amendment, i.e., I.R.C. section 482, Congress has seemingly imposed a perfect hindsight rule with no safe harbors for U.S. companies.¹⁰⁷ The result is sure to be increased litigation under section 482. High-Tech, and taxpayers similarly situ-

¹⁰² The valuation methods for tangible property includes: the comparable uncontrolled price method; the resale price method; the cost plus method; unspecified methods; and the comparable profits method. Temp. Treas. Reg. §§ 1.482-3T(b)-(e) (1994).

¹⁰³ See, e.g., COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GENERAL ACCOUNTING OFFICE, GGD 81-81, REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS OF THE UNITED STATES: IRS COULD BETTER PROTECT U.S. INTERESTS IN DETERMINING THE INCOME OF MULTINATIONAL CORPORATIONS 31 (1981) (finding that even though more specific methods were available, the IRS uses the "other method" to collect 86% of the tax liabilities under I.R.C. § 482).

¹⁰⁴ In order to use the "other method," a taxpayer must disclose the use of the method by attaching an appropriate disclosure statement to the timely filed return. Temp. Treas. Reg. § 1.6662-6T (d) (3) (iii) (C) (1994).

¹⁰⁵ The taxpayer must prepare "contemporaneous supporting documentation setting forth: the specific analysis adopted, an analysis of why the method used provides the most accurate measure and the data supporting its application." Temp. Treas. Reg. § 1.6662-6T(d)(2)(iii) (1994).

Some analysts, however, report that the compliance costs have run as high as \$1,000,000 to some firms. *Transfer Pricing: Firms Should Scrutinize Pricing Methods to Avoid Stiff Penalties Under Final Rules*, Daily Tax Rep. (BNA) No. 137, at D8 (July 20, 1994).

¹⁰⁶ Penalties for valuation errors under § 482 are severe. For reallocations exceeding \$5,000,000, the penalty is 20% of the tax under payment. I.R.C. § 6662(a) and (e)(1)(B)(ii) (1994). If the reallocation exceeds \$20,000,000, the penalty is 40% of the tax under payment. I.R.C. § 6662(a) and (h) (1994).

Even if the taxpayer provides all of the documentation requested, such compliance in itself will not be a sufficient basis to establish the reasonable cause and good faith exception for the imposition of penalties for valuation errors. Temp. Treas. Reg. § 1.6662-6T(d) (1994).

¹⁰⁷ There is limited help for the taxpayer through the Advance Pricing Agreement Program (APA). See Rev. Proc. 91-22, 1991-1 C.B. 526. The APA program enables a taxpayer to reach agreement with the Internal Revenue Service on the appropriate transfer pricing method to be used. When an APA agreement is reached, allocation under I.R.C. § 482 is permitted only to the extent provided in the APA agreement itself. See generally Intercompany Transfer Pricing Regulations Under Section 482, 58 Fed. Reg. 5263 (1993) (amending 26 C.F.R. §§ 1, 602). The APA Program has not gained widespread usage. Enacted in 1991, the IRS reported 70 taxpayers in the program as of the end of the first quarter in 1994. *Transfer Pricing: IRS Says APA Requests Split 50-50 Between U.S. Parent and Foreign Parent Companies*, Daily Tax Rep. (BNA) No. 61, at D-4 (Mar. 31, 1994).

ated, will be at a decided disadvantage,¹⁰⁸ and subjected to a whipsaw effect on the earnings of their controlled foreign corporations.¹⁰⁹

2. *The Impact on the Transfer of Technology*

The tax uncertainty can be particularly harmful to new innovative companies like High-Tech.¹¹⁰ The tax uncertainty, coupled with product development risks and business problems normally associated with international operations, could operate in unison to deter companies from transferring technology transnationally.

U.S. technological advantage could be eroded by the amendment; tax cost uncertainties discourage product development and refinement because profitable foreign market activity cannot be assured. The problem may be compounded by the reaction of our trading partners.¹¹¹

3. *The Effect on U.S. International Obligations*

The United States as a member of the Organisation of Economic Cooperation and Development (OECD)¹¹² espouses the arm's-length standard for intercompany pricing,¹¹³ often criticizing those states that have not supported the standard.¹¹⁴ The new standard subordinates the arm's-length approach. Recognizing this change in position, OECD treaty partners have expressed reservations about potential adjustments under I.R.C. section 482, and are threatening to pass retaliatory legislation.¹¹⁵

¹⁰⁸ Civil judicial resolution of tax disputes requires the taxpayer to sustain its position by a preponderance of the evidence; litigation involving a § 482 adjustment requires the taxpayer to show that the Service has abused its discretion by being "arbitrary, capricious or unreasonable . . ." *Pauline W. Ach v. Commissioner*, 42 T.C. 114, 125-26 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966) (creating a much higher standard).

¹⁰⁹ If the Service adjusts income pursuant to § 482, the foreign country would likely not respect the adjustment, as the foreign governments will most likely not allow a U.S. government decision to impact the way they calculate taxes. Thus, the incremental adjustment to royalties would probably not be a deductible expense in the foreign country.

¹¹⁰ The amendment covers transfers made after November 16, 1985. As such, "the brunt of the effect of the new law will be felt by emerging . . . high tech companies; . . . [t]hese are the companies . . . marketing new products . . ." See Aud & Wright, *supra* note 85, at 19.

¹¹¹ According to Price Waterhouse International Tax Review, aggressive U.S. transfer pricing policies are leading some Organization of Economic Cooperation and Development (OECD) countries to retaliate against subsidiaries of U.S. multinational companies. *Taxleads*, Daily Tax Rep. (BNA) No. 63, at D-11 (Apr. 14, 1994).

¹¹² The OECD is a multilateral treaty entered into force on December 14, 1960. Including the United States, there are 21 signatory countries. One of its principle purposes is to "contribute to the expansion of world trade on a multilateral non-discriminatory basis . . ." Convention on the Organisation for Economic Cooperation and Development, Dec. 14, 1960, art. 1, 12 U.S.T. 1730, 1732 T.I.A.S. No. 4891.

¹¹³ See Levey & Ruchelman, *supra* note 72, at 640-41.

¹¹⁴ See Aud & Wright, *supra* note 85, at 19.

¹¹⁵ See *supra* note 111 and accompanying text.

B. Possible Solutions to the Problem

Creating certainty in the tax implications of technology transfers is very important.¹¹⁶ The government should have the burden of setting valuation parameters. The government has the ability to accumulate information from diverse taxpayers. This power should be used to establish a database for comparables.¹¹⁷ Private taxpayers, in contrast, cannot effectively assemble such a database. Working in cooperation with the governments of the OECD, the United States could assemble information on worldwide royalty payments to establish the comparables database.

Certainty could also be provided to the taxpayer by simply including the income generated by the foreign subsidiary as Subpart F income.¹¹⁸ This would subject the income from marketing the intangible to U.S. income tax as it is earned. There would be no reason to manipulate the price in that case, and the result would be more certainty for the taxpayer.

Finally, the amendment could be repealed and pre-1986 I.R.C. section 482 regulations used to determine the valuation of the intangible.¹¹⁹ At the very least, the draconian penalty rules should be repealed or modified.¹²⁰ Absent statutory clarity, penalties should not be imposed where taxpayer willfulness is not found.

At present, the amendment and regulations stifle international transfer of technology, disrupt international obligations, and invite retaliation from our trading partners. Ironically, by engendering unpredictability, existing tax provisions run at cross purposes to U.S. trade policy which increasingly promotes the transfer of technology.

¹¹⁶ See *supra* part IV.B.

¹¹⁷ The United States is already using this power against taxpayers. For example, in *Nesle Holdings, Inc. v. Commissioner*, 94 T.C. 803 (1990), the Service determined that the values used by the taxpayer were not proper. However, in pretrial activity the Service had engaged in a mass mail-out of letters in search of comparables. Eileen M. Drage, *International Taxes: IRS Seeking 'Nesle' Case Comparables With Mass Mailings*, *Tax Practitioners Say*, Daily Tax Rep. (BNA) No. 66, at D-14 (Apr. 7, 1994). Two problems are apparent: (1) If the IRS is only now searching for comparables, how did they know the taxpayer was wrong? (2) If the only way to know the correct amount is through these mass mailings how can the taxpayer ever obtain such information.

¹¹⁸ See Kaplan, *supra* note 76, at 325. See also *supra* notes 61-62 and accompanying text.

¹¹⁹ Some commentators believe that effective and appropriate application of pre-1986 Temp. Treas. Reg. § 1.482-2(d) can prevent the abuses with which Congress was concerned. See Aud & Wright, *supra* note 85, at 21.

¹²⁰ See *supra* notes 46, 104-06 and accompanying text.

